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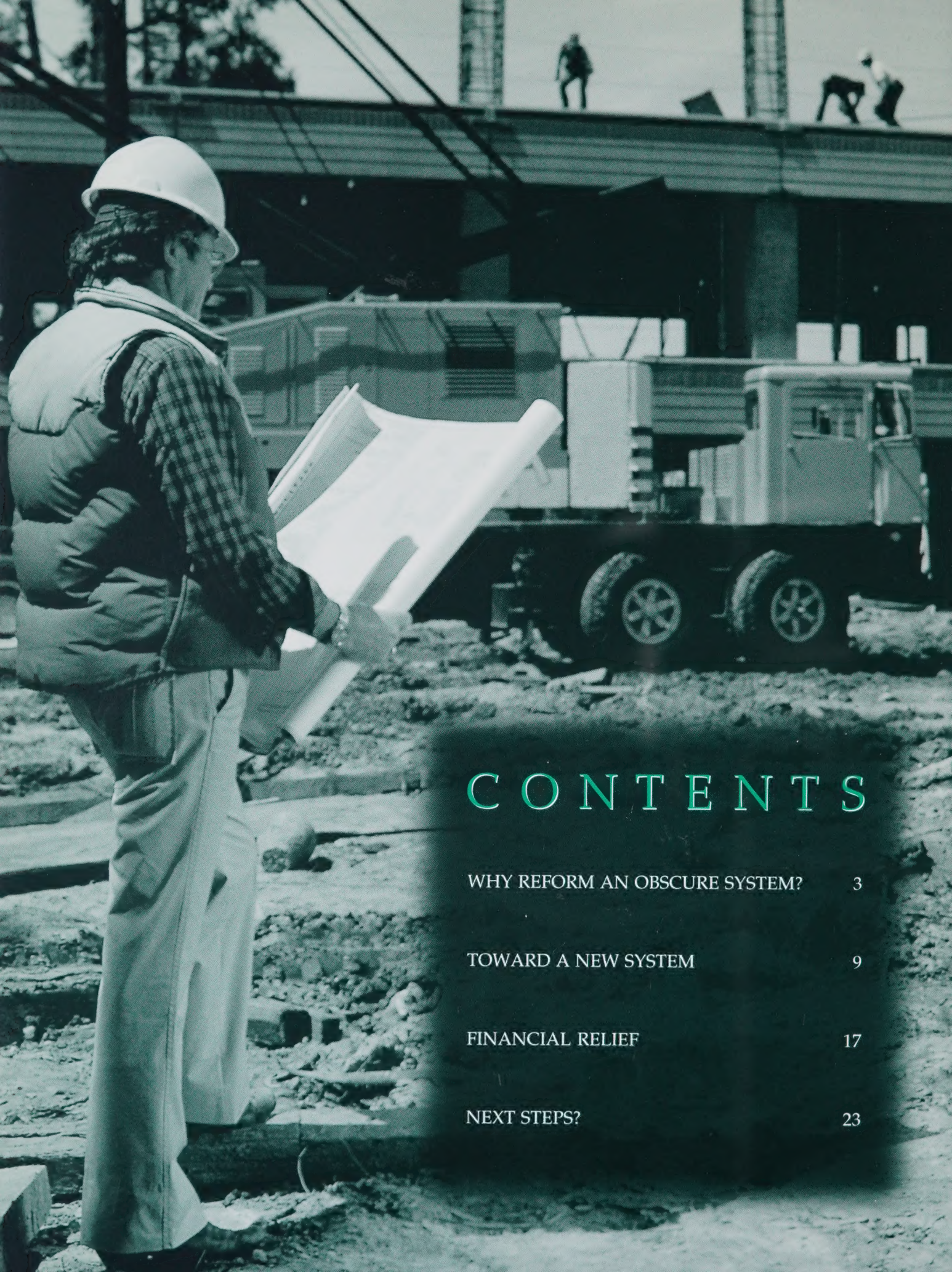
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FISCAL REFORM IN CALIFORNIA



SAN DIEGO ASSOCIATION OF GOVERNMENTS



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WHY REFORM AN OBSCURE SYSTEM?

Almost invisible, the state-local tax system in California is not well understood, even by people directly involved in the transactions. Yet, at the local level, the system is crucial to our ability to manage growth smartly, to provide enough homes for our residents, to maintain public services, and to sustain the region's resurgent economic performance.

The current tax system is an impediment to sustainable communities. It restricts the freedom of local governments to manage their own fiscal affairs and thereby destabilizes local governments. It impedes home construction and encourages cities to compete among themselves for the weakest contributors to economic prosperity — retail outlets.

In short, the current tax system adversely affects how our communities look, and, even more important, how they work.

FISCAL INSTABILITY: THE MONEY SHUFFLE

Over the past 20 years, voter-approved tax limitations have substantially diminished local government's fiscal powers, reduced revenues, and put the state government in charge of allocating property taxes among local agencies.

State budgetary actions in the early 1980's and early 1990's further reduced local revenues. Six subventions to cities and counties were repealed by the state.

Most significantly, the state ordered an ongoing 25% cut in local government's property tax base beginning in fiscal year 1992-93. Each county was required to set up an Educational Revenue Augmentation Fund (ERAF) and to deposit into the fund each year a portion of the property taxes that otherwise would have accrued to local governments. The state uses these revenues to meet its constitutional obligation to provide a minimum level of funding for public schools. (See inset on ERAF discussion on page 21.)

It is not coincidental that the property tax shifts and the other state takeaways occurred when they did. The early 1980's and early 1990's were recessionary times in California. Facing budget deficits, the state took local money instead of cutting its spending or raising state taxes. The state government has been balancing its own budget by appropriating local revenues.

The state hasn't always been a usurper of local funds. After the passage of Proposition 13 in 1978, the state responded to the sharp cut in property taxes by shifting property tax revenues from school districts to local governments and by assuming a larger share of the responsibility for funding the public school system.



The people of California are losing control over the public services dearest to them because local governments are losing the freedom to manage their own fiscal affairs.

W H Y R E F O R M A N O B S C U R E S Y S T E M ?

Also, in recent years, the State Legislature has acted to offset the losses caused by the ERAF property tax shifts by allocating more money for local government programs.¹ Despite the relief, most cities and counties remain net losers.² In addition, unlike the property taxes taken away, the relief has come with programmatic earmarks, restrictions, and complicated allocation formulae.

IT'S ABOUT MORE THAN MONEY

That local governments have lost revenue over the years is almost beside the point. The state's long-term proclivity to shuffle money between itself and units of local government fosters instability for governments throughout California. It also creates divisions among cities,

counties, schools, and special districts. Public agencies work best for the people when they cooperate.

Each year, local agencies scurry to make major changes to their spending plans and service levels based on the outcome of the state budgetary process. The unpredictability of government budgets at the local level disrupts the delivery of public services and renders local financing plans for infrastructure unduly tentative. The instability hardly is conducive to growth management and sustainable prosperity in California.

California's economy is the aggregate of local/regional economies, all of which would perform better if local governments were fiscally stable.

Balancing the State's Budget with Local Revenues During Bad Economic Times

Recession 1990-1994:

ERAF Property Tax Shifts from Local Agencies
1993, 1994 & to the present

Cigarette Tax Revenues
Repeal of subvention to cities and counties, 1992

Trailer/Mobilehome License Fees
Repeal of subvention to cities and counties, 1992

Recession 1982-1984:

Business Inventory Exemption
Repeal of reimbursement to local agencies, 1984

Financial Aid to Local Agencies Fund
Repeal of subvention to cities and counties, 1982

Highway Carriers Uniform Business Tax
Repeal of subvention to cities, 1982

Liquor License Fees
Repeal of subvention to cities and counties, 1982

Source: State Board of Equalization and SANDAG.

¹ Most notably Proposition 172 (public safety ½-cent sales tax), trial court funding reform, and Citizens Option for Public Safety (COPS).

² Source: California Legislative Analyst's Office, *Shifting Gears: Rethinking Property Tax Shift Relief*, February, 2, 1999.



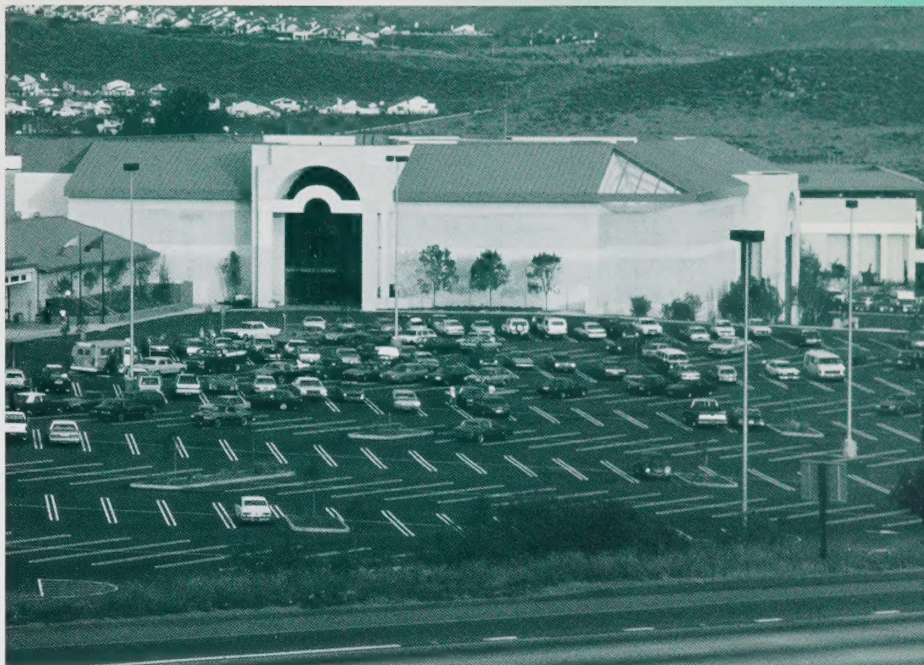
FISCALIZATION OF LAND USE

Having lost much of their control over tax rates and revenues, local governments are trying to regain their fiscal powers through land use policy. They want new development that produces taxable sales. They are less interested in accommodating housing and other non-commercial projects, even though such projects may be more beneficial for local residents, the community, and the region.

Under financial pressure, cities are retreating from their responsibility for accommodating the state's urban population growth. The California Planning Roundtable put it this way:

*"Many local governments have no incentive to approve much-needed housing projects — especially affordable housing projects — because they are money-losers for the local budget . . . While rejecting housing, cities and counties have engaged in destructive competition for retail development."*³

As jurisdictions accommodate tax-producing development, land uses that should be integrated into each community become concentrated in separate communities, creating imbalance in a region or subregion. Some communities may successfully attract a disproportionate share of the region's commercial development and jobs, while forcing housing projects into distant suburbs and rural areas.



The imbalance in the geographic distribution of shopping opportunities, jobs, and housing increases and lengthens car trips, adds to traffic congestion, and degrades air quality. It also wastes people's time and money.

Unfortunately, inter-jurisdictional competition for retailers diverts attention and resources away from other land uses, higher-paying jobs, and housing opportunities. And the competition does not even build California's or a region's retail base; private market forces do that quite independently of government suasion in response to rising consumer demand.

Under financial pressure, cities are retreating from their responsibility for accommodating the state's urban population growth.

³ The California Planning Roundtable is a statewide organization of professional planners. The quote is taken from: *Restoring the Balance: Managing Fiscal Issues and Land-Use Planning Decisions in California*, 1997.

Local land use policy has emerged as a powerful revenue-raising tool, setting the stage for more frequent conflicts between governmental money needs and community needs.

Indeed, "fiscalization of land use" leads to distorted public policy: the health of the municipal budget is mistaken for the community's economic prosperity; retail development is confused with economic development; and, the most important community need — housing — is regarded as a loser.

The people of California are poorly served when the pursuit of tax dollars underpins local decisions about land use and community development.

UNBEARABLY COMPLICATED

The complexity of the state-local financial relationship hinders efforts to reform it. The general public hardly can be expected to rise in support of changing an obscure tax system that ostensibly involves only intergovernmental relations.

Presumably aware of the broad impacts of the state-local tax system, the State Legislature continues its 20-year preoccupation with local fiscal affairs. The results so far: more rules and earmarks, greater state control, more money shifting among units of government, greater friction among governments, and more uncertainty in the financing of public facilities and services for local residents.

A POLICY PRESCRIPTION

Overcoming or avoiding the problems outlined above will not be an easy task because the solutions entail reform of California's system of municipal finance. While some feel changes to Proposition 13 would be helpful, this constitutional amendment is immensely popular, and it likely will stay in place.



Another legislative approach would be to seek a change to the existing *situs* method for allocating the local sales tax. However, that option would face fierce opposition from California's largest cities, and the specter of winners and losers, even among smaller jurisdictions, would render the proposal unacceptable to many communities throughout the state.

Alternatively, California should pursue an approach to state-local fiscal reform that conforms to all voter-approved tax initiatives and keeps all public agencies fiscally whole. Further, the approach should not only neutralize the influence of taxable retail sales on land use decisions but also restore fiscal stability and local control to local government.

REFORM AND RELIEF

In addition to fiscal reform, most local governments need financial relief in the form of additional revenues to pay for public services and facilities, especially infrastructure improvements in older, urban neighborhoods. But, unlike *relief*, *fiscal reform* for cities and counties can be accomplished without raising taxes or taking money from other public agencies.



Although this report discusses a couple of ways to provide financial relief for local agencies, it emphasizes the need for fundamental, "revenue-neutral" reform. Fiscal reform and financial relief can fit together, but relief without reform could prove to be a fleeting remedy for a dysfunctional state-local financial relationship.

Unlike *relief*, *fiscal reform* for cities and counties can be accomplished without raising taxes or taking money from other public agencies.



TOWARD A NEW SYSTEM

More than ever, California needs a new state-local financial relationship—one that benefits all of our communities and helps create fiscally stable cities and counties. Such a system is possible, and it can be created without raising taxes or changing any voter-approved tax measure, such as Proposition 13.

A new system should be developed and predicated on the principles outlined below.

PRINCIPLES FOR REFORM

Principle One: Protect Local Revenues

Local government should have constitutionally-protected revenue sources, including dedicated minimum shares of the property tax and sales tax.

Local government will never achieve a modicum of financial security so long as the state can routinely appropriate local funding sources as part of the annual budgetary process in Sacramento. Cities and counties should have constitutional protection for their most important revenue sources.

Principle Two: Simplify & Add Flexibility

The number of revenue sources shared between state and local government should be reduced, and the consolidation should produce larger shares of discretionary property and sales taxes for local government. The additional share of sales taxes for local government should be allocated among local agencies based on population rather than *situs* or where the sales transaction occurs.

That local agencies should have a larger, protected share of the property tax in lieu of other state-controlled subventions makes sense for several reasons. The property tax is assessed, collected, and appealed locally. Taxpayers understand the relationship between property taxes and local services. Furthermore, the property tax is a stable revenue source.

With greater reliance on property and sales tax revenues, local agencies would be able to influence to a larger degree their own financial destiny through land use and economic policy.

The State's administrative charge to collect and send vehicle license fees (VLF) to cities and counties: \$180 million/year . . .

Why doesn't the state simply keep all of the money from the VLF and give local governments a larger share of the property tax in exchange?

**Principle Three:
Keep Faith with the Voters**

Fiscal reform should proceed without imposing additional burdens on taxpayers and without changing any voter-approved tax limitation, including Proposition 13.

The voters of California ultimately will decide on the fate of any fiscal reform that proposes constitutional change. They should not be asked to pay higher taxes for this purpose.

Tax dollars
raised locally
should stay local.

**Principle Four:
Keep Fiscally Whole All Units of
Government and Schools**

Fiscal reform should not worsen the fiscal status of local government, state government, or public schools.

Distinct from tax relief, fundamental reform of the state-local tax system should be "revenue neutral," avoiding reform's worst enemy — the specter of winners and losers.

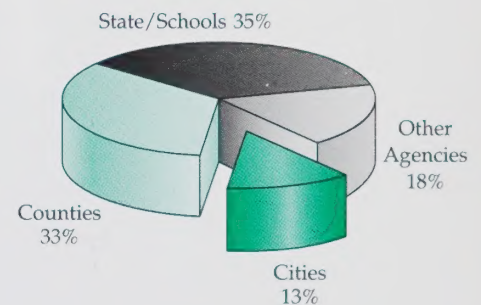
**Principle Five:
Strengthen Growth
Management Incentives**

Changes to the tax system should reduce inter-jurisdictional competition for commercial development, promote regional cooperation, and give cities a greater financial incentive to accommodate new housing demand.

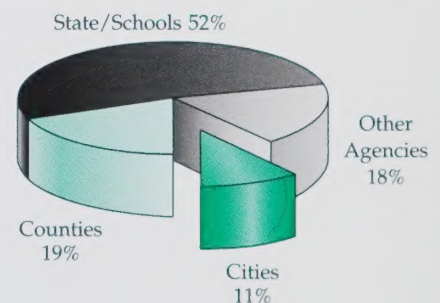
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Share of the Local Property Tax

FY 1990



FY 1998



Source: State Board of Equalization, *Annual Reports*, FY 1989-90, and FY 1997-98.



A NEW SYSTEM ILLUSTRATED

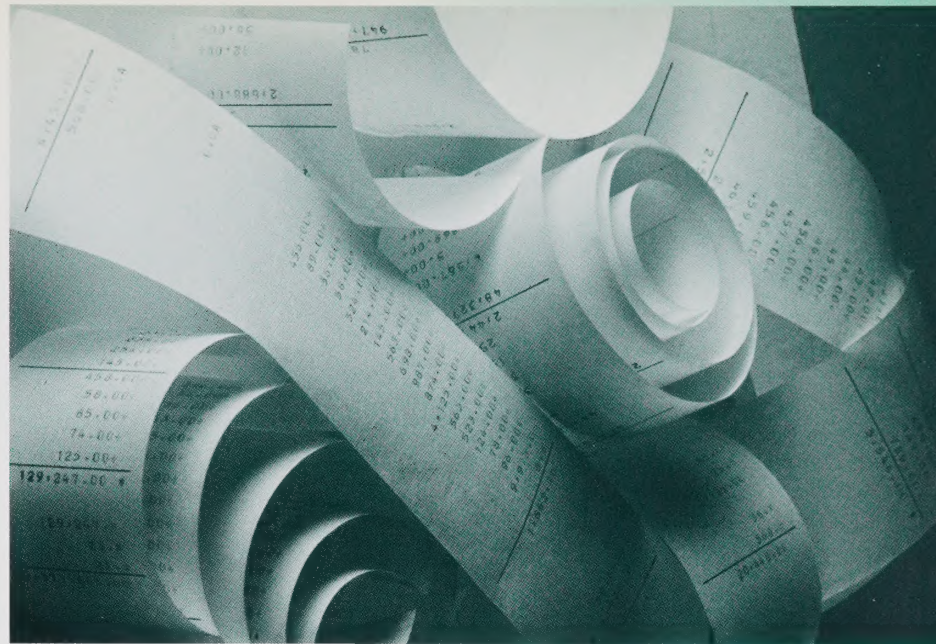
A new state-local tax system, consistent with the principles cited above, could be implemented through constitutional change, including an even exchange of revenues between local governments and the state. The elements of such a system, including dollar impacts, are illustrated below:

1

Constitutional Minimum Guarantee of Revenues

Constitutional change should guarantee local government's share of the property tax and sales tax and raise local government's share of both. The additional property taxes and sales taxes could be derived from an even exchange of revenues with the state (see #2 below). Any reversal of the ERAF property tax shift should receive constitutional protection as well, adding to the minimum guarantee.

Under this approach, the existing 1-cent local sales tax (Bradley-Burns) would continue to be distributed among agencies based on point-of-sale, as currently done by the State Board of Equalization. The only change here would be constitutional protection of this local revenue source, including the current *situs* allocation method.



Likewise, the allocation of local government's *existing* shares of the property tax would remain unchanged. Each city and county would continue to receive its current share of property taxes collected from each tax rate area within its jurisdiction. Again, the only difference would be a constitutional safeguard for these existing percentage shares.

2

Extended Protection: Exchange of State Controlled Revenues for Local Dollars

Constitutional reform could provide for an even exchange of revenue between the state and local government, as illustrated in the table on page 12. For example, cities and counties in California could "cash in" nearly \$4.5 billion in state controlled dollars for an equivalent amount of dollars in the form of a larger share of property taxes and sales taxes. While the table on the next page shows statewide dollar amounts, the even exchange of revenues could be transacted on a county-by-county basis.

Six state subventions to local communities have been repealed since 1982.

Three sizable subventions are left for local agencies:

1. Vehicle License Fees
2. Gas Tax
3. Rebate for Homeowners' Exemption

Example: Statewide Even Exchange of Revenue in Base Year
FY 1999 - 2000

A \$4.5 billion trade to
untangle state and local
government finance and
to extend constitutional
protection to more
local dollars.

Cities & Counties Receive (\$Millions)		The State Retains (\$Millions)	
General Fund Revenue:	Annual Revenue*	Annual Revenue*	For Deposit to:
Larger share of property taxes	\$ 2,476	Vehicle license fees ¹	\$ 3,033 State General Fund
Extra 1/2-cent local sales tax (State's rate reduced 1/2 cent)	\$ 1,977	Gas taxes ²	1,031 State Highway Account
Total	\$ 4,453	Rebate- Homeowners' exemption	389 State General Fund
		Total	\$ 4,453

* Based on estimated revenues reported by the State Controller.

¹ Includes backfill revenues for car tax reduction. Excludes state administrative charges for apportionment to cities and counties. Also excludes county health and welfare realignment revenues of 24.33% of total vehicle license fee revenue.

² Excludes state administrative charges for apportionments to cities and counties.



From each county, the state could retain revenues it currently allocates to cities and the county government, including vehicle license fees, gas taxes, the reimbursement for the homeowners' property tax exemption,⁴ and other subventions to local agencies.

In exchange, each county could be allocated a larger share of the existing state sales tax equal to ½ cent. The state's share of the sales tax rate would be reduced by ½ cent, leaving unchanged the combined rate in California, as shown on page 13.

⁴ Homeowners would continue to receive the property tax exemption, but the state's annual reimbursement for the reduction in local government revenue would be replaced permanently with an additional share of the local property tax.

To balance the revenue exchange, each county also would receive a larger share of the property tax. Therefore, counties with a relatively low level of taxable sales (i.e., lower revenue from a ½-cent sales tax) would receive a relatively higher proportion of property taxes in order to keep the revenue swap neutral.

The revenue exchange shown in the table on page 12 involves only three state apportionments to local governments.⁵ However, the swap could be expanded. Local governments could receive an even larger share of the property tax in exchange for other state-controlled taxes and fees, such as California vehicle code fines, off-highway license fees, and open space subventions.



Along with existing revenues from the property tax and sales tax, the new local dollars (property taxes and sales taxes) would be constitutionally protected without earmarks or other complications that reduce the value of money and give rise to needless bureaucracy.

Revenue realignment:
Is not an un-
encumbered, secure
dollar more valuable
than an uncertain,
restricted dollar?

Current California Sales & Use Tax Rate
& Change under Revenue Exchange

	Current Rate	New Rate
State Sales & Use Tax		
State General Fund	5.0 cents	4.5 cents
Local Sales & Use Tax (Bradley-Burns)		
City & county general funds	1.0	1.5
Prop. 172 - Local Public Safety Fund		
Local public safety programs	0.5	0.5
State Revenue Fund		
For County health & social services	0.5	0.5
County Transportation Tax		
Public transportation	0.25	0.25
Statewide Minimum Tax Rate*	7.25 cents	7.25 cents

* Does not include optional local sales tax rates levied by districts in the state.

In San Diego County, SANDAG, serving as the Regional Transportation Commission, levies a voter-approved rate of 0.5 cents, raising the total rate to 7.75 cents.

⁵ A fiscal reform previously proposed by SANDAG included local Transportation Development Act (TDA) funds (.25-cent sales tax) as part of the revenue exchange. Because TDA funds have since received constitutional protection for public transit purposes, these dollars have been excluded from the revenue exchange illustrated above.

The revenue exchange between the state and local governments would be transacted on a dollar-for-dollar basis in the base year.

Statewide, the larger share of property taxes for cities and counties would total nearly \$2.5 billion annually, or about three-fourths of the current ERAF shift from cities and counties to schools.

The state would replace the property taxes shifted from schools with additional state aid to education using revenues acquired from local governments as part of the revenue exchange. And this could be accomplished without reducing the total amount of revenues available to the state or public schools.

3

Creation of a Countywide Tax Base

For each county, the local dollars acquired through the revenue exchange with the state would be deposited in Local Revenue Fund. Again, these revenues would include a larger share of local property taxes for cities and the county government and proceeds from a portion of the sales tax (½ cent) that currently accrues to the state.



⁶ The form and content of such an agreement is outlined in a previous SANDAG publication, *A Proposal for State-Local Fiscal Reform in California*, March 1998.

The “pooling” of these revenues on a countywide basis would make it possible to equalize the revenue exchange for each city and the county government.

The revenue exchange between the state and local governments would be transacted on a dollar-for-dollar basis in the base year. Thereafter, the amount of revenue received by local governments would change as a function of the new countywide tax base — the assessed value of property and taxable sales (½-cent sales tax).

4

Revenue Allocation from the Local Revenue Fund

The revenues deposited in each county's Local Revenue Fund could be apportioned among local agencies by a state agency. Alternatively, local governments in each county could be given the option to allocate the funds pursuant to an areawide agreement or joint exercise of powers.⁶ In either case, a constitutional amendment could set the allocation method for the Local Revenue Fund as follows:

"Hold Harmless" Rule for Annual Base Amount of Revenue

This provision would ensure that each agency receives a base amount of annual revenue *equal* to the amount it relinquished to the state as part of the revenue exchange.

The hold harmless rule would establish each city's and the county government's minimum level of annual revenues on an ongoing basis. In addition to this base amount, each agency would receive a share of the annual "tax increment," or revenue growth from the countywide tax base created as the result of the revenue exchange.

Allocation of the Annual Tax Increment

In each county, cities and the county government could be allocated a share of the annual revenue growth, or tax increment, from the countywide tax base as follows:

County Government's Share of Tax Increment

Equal to the same percentage share of total revenues it received in the base year under the hold harmless rule.

Cities' Share of Tax Increment

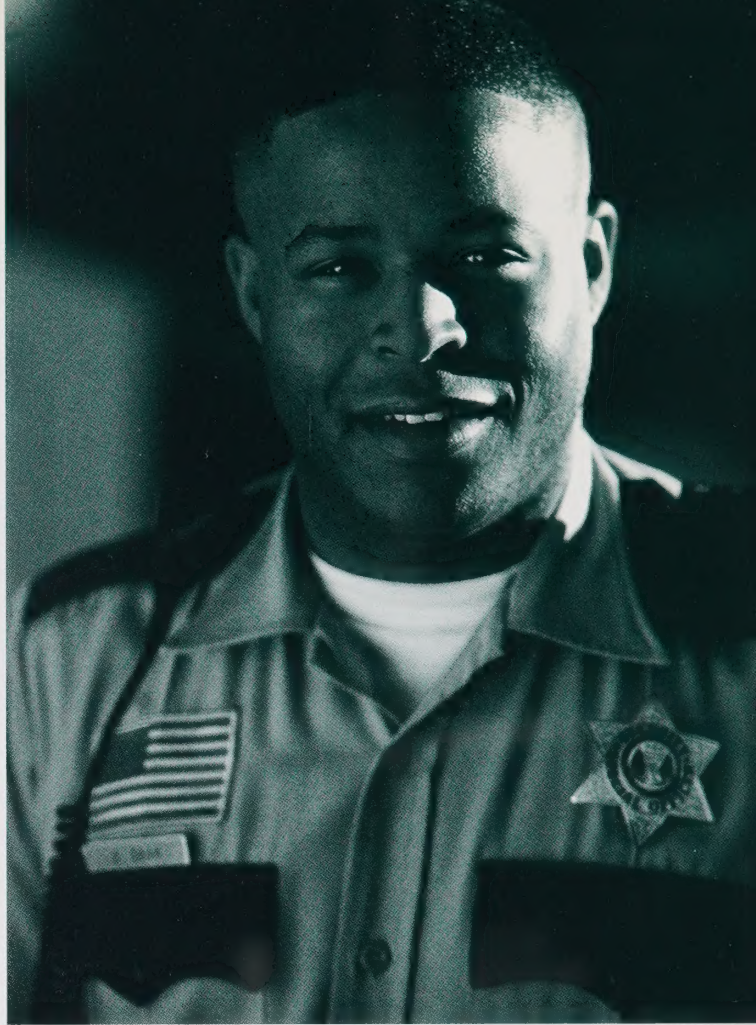
Equal to the same percentage share of total revenues cities received in the base year under the hold harmless rule. The cities' share then could be further allocated among individual cities on the basis of total population.



In this way, cities that experience relatively more housing and population growth would receive more revenue from the countywide tax base. Both property taxes and sales taxes from the countywide tax base would support residential development, providing a greater incentive for local governments to accommodate housing. And, over time, the annual tax increment would grow relative to the size of the annual base amount of revenues.

Such an approach to revenue sharing from a countywide tax base could reduce competition for retail development and promote regional cooperation in economic development. Cities, as well as the county government, would receive a financial return based on the performance of the regional economy. All jurisdictions would benefit to the extent the regional tax base increased as the result of growth in the assessed value of property and taxable sales.

The "hold harmless" rule would establish each city's and the county government's minimum level of annual revenues on an ongoing basis.



FINANCIAL RELIEF

Local governments also need financial relief. Having lost revenues and fiscal powers over the past two decades, local public agencies are finding it increasingly difficult to meet the public service demands related to California's population and housing growth. The financing of public services in residential communities, particularly older neighborhoods, is burdensome because cities receive such a small share of the local property tax, averaging only 11% statewide and 13% in the San Diego region.

While reliance on development impact fees has offset the cost of new public facilities in developing areas, the fees do not produce enough revenue to pay for redevelopment and infrastructure reinvestment in older, urban neighborhoods. Further, general tax increases face an insurmountable hurdle — two-thirds voter approval.

Financial relief for cities and counties could take many forms. Following is a brief discussion of only two proposals that have the potential to not only increase local revenues but also help achieve smart growth objectives. Both proposals would cost the state government money. They include:

- ♦ Full or Partial Reversal of the ERAF Property Tax Shift, and
- ♦ Pooling Existing Sales Taxes and State Matching Funds

REVERSAL OF THE ERAF PROPERTY TAX SHIFT

"Reversal of the ERAF" has been a high legislative priority of local governments ever since the property tax shift was instituted in the early 1990's. (See inset on ERAF discussion on page 21.) This legislative proposal would reduce or terminate the annual shift of property taxes from local governments to schools. Ordered by the state legislature, the initial shift occurred in fiscal year 1992-93 and was increased substantially in following year, 1993-94.

The annual shift now totals about \$3.6 billion statewide, or one in five property tax dollars. In the San Diego region, the shift is about \$215 million annually and has totaled over \$1.26 billion during the past seven years.

One of the advantages of reversing the ERAF shift is that it would increase the amount of property tax revenue that cities and counties receive from housing development, helping to neutralize the effects of the sales tax on land use decisions.

Also, local governments would have more revenue to pay for needed services in residential neighborhoods. Moreover, infill housing and redevelopment would yield more public revenues to pay for infrastructure investment in older communities.

Proposed ERAF reversal without constitutional protection for local agencies would be more of the same, not reform.



**San Diego Region ERAF Property Tax Loss
Combined 7-Year Loss: \$1.26 Billion**



Source: County of San Diego, Auditor and Controller's Office

The state would incur the cost of any full or partial ERAF reversal. Under the constitution, the state would have to replace the property tax dollars with state general fund allocations to public schools in California.

Importantly, any reversal of ERAF should come with constitutional assurances that local governments will be able to keep the revenues. Otherwise, what should local governments prudently do with the extra property tax revenue? Should they program the revenues in the long-term capital facilities program, or should they save the money, in the event the ERAF is later reinstated after the state surplus is gone and the state encounters budget problems?

Without revenue protection for local governments, a reversal of ERAF would perpetuate a fundamental problem: state manipulation of local revenues and the fiscal instability it engenders.

POOLING SALES TAXES AND STATE MATCHING FUNDS

Under this proposal, local agencies in each county would have the option to establish a pool of revenues derived from the *growth* in one-half of the existing 1-cent local sales tax (Bradley-Burns) in their jurisdictions.⁷ The state would match the dollars in the pool 1:1, if the participating agencies serve an area coincident with the jurisdiction of the county or council of governments. This proposal is similar to a policy option being considered by the Speaker's Commission on State/Local Government Finance.⁸

Local agencies would create the pool through a joint powers authority (JPA). The amount of sales tax revenue put into the pool would not be cumulative, but rather limited to one-half of the growth in the previous year's sales tax revenue in those jurisdictions that



⁷ This approach should not be confused with the fiscal reform illustrated previously. That example would create countywide tax base consisting of property taxes and an additional ½-cent local share of the existing state sales tax.

⁸ Assembly Speaker Villaraigosa created this commission in early 1999 to evaluate potential reforms to California's system of local government finance. After it completes a series of public hearings, the commission will make recommendations to the Legislature in early 2000.



participate in the pool. The sales tax revenues would be allocated among the participating agencies based on total population or another factor to which the agencies agree.

The state matching funds would be allocated among local agencies based on a formula that recognizes specific policy objectives of both regional and statewide significance, such as jobs-housing balance, real income growth, infrastructure investment in older communities, and/or the provision of affordable housing. Working with each JPA, the State Legislature would define the allocation criteria for the matching funds.

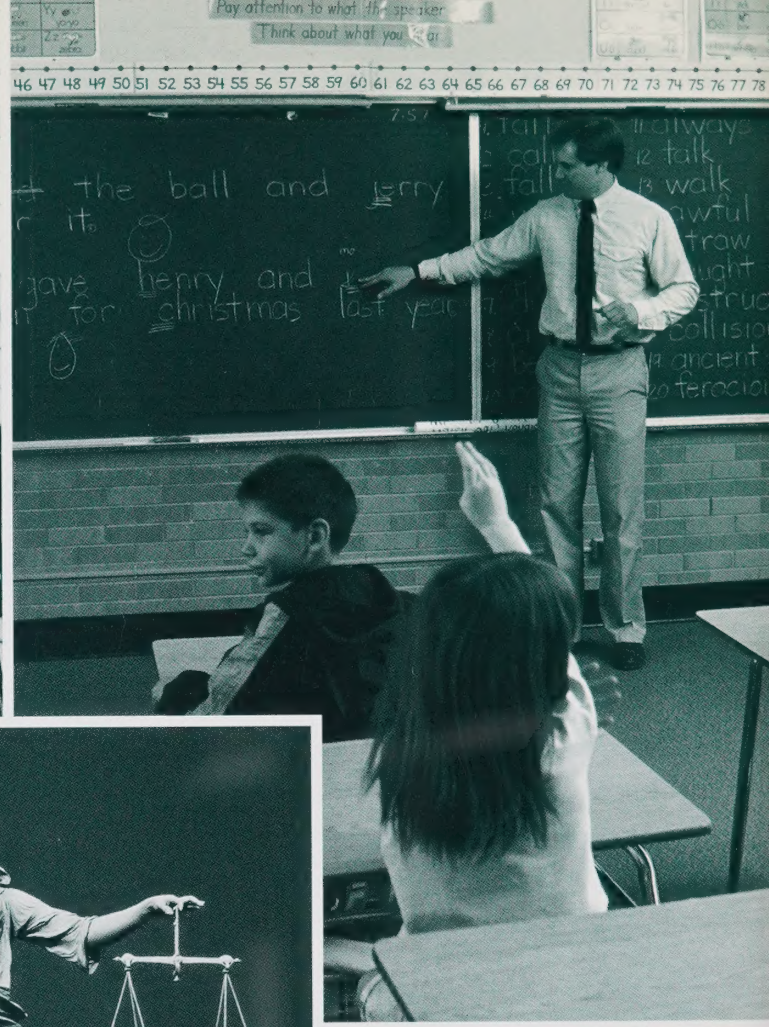
This proposal would initially cost the state about \$105 million annually assuming growth in statewide taxable sales of 6%. The amount of the matching funds would increase over time with increases in the level of taxable sales countywide.

This proposal would do more than provide financial relief for most local governments. It also would promote inter-jurisdictional cooperation in economic development and growth management, reduce the influence of sales taxes in land use decisions, and help achieve smart growth principles of regional and statewide significance.

Example of State Matching Funds for Cities/County Pooling of Local Sales Taxes

	Based on Revenue for 1997-98	
	California	San Diego Region
Existing 1-cent Local Sales Tax	\$ 3,487,012,000	\$ 284,165,843
Growth, Assuming 6% Increase	\$ 209,220,720	\$ 17,049,950
Subtotal	\$ 3,696,232,720	\$ 301,215,793
Contribution to Revenue Pool One-Half of Sales Tax Growth*	(104,610,360)	(8,524,975)
Net Amount	\$ 3,591,622,360	\$ 292,690,818
Countywide Revenue Pool:		
One-Half of Each City's and the County's Sales Tax Growth*	\$ 104,610,360	\$ 8,524,975
State Matching Funds	\$ 104,610,360	\$ 8,524,975
Total Revenue Pool	\$ 209,220,720	\$ 17,049,950
Total Revenue For Local Governments	\$ 3,800,843,080	\$ 309,740,768

* Assumes that sales tax revenues grow by 6.0% annually.



EDUCATIONAL REVENUE AUGMENTATION FUND (ERAF): A LONG-STANDING RIFT BETWEEN STATE AND LOCAL GOVERNMENTS

In the early 1990's, the State Legislature faced large budget deficits caused by a severe economic downturn in California. To raise revenue, the Legislature enacted legislation requiring every county in California to set up an Educational Revenue Augmentation Fund (ERAF) and to deposit into the fund each year a portion of the property taxes that otherwise would have accrued to cities, counties, special districts, and redevelopment agencies.⁹ These revenues are used to support school districts.

The property tax shifts from local governments to schools have reduced, dollar-for-dollar, the amount the state is required to spend each year for schools under Proposition 98, a constitutional amendment passed by the voters in 1988. Despite its name, the ERAF does not "augment" school funding: It simply puts the state's constitutional obligation to provide a minimum level of school funding partly on the shoulders of local government.

ERAF PROPERTY TAX SHIFT TO SCHOOLS

	Annual Loss in Property Tax Revenue (In \$Millions)		
	1st Year 1992-93	2nd Year 1993-94	7th Year 1998-99*
California Counties, Cities, & Other Local Agencies	\$1,400	\$4,045	\$3,620
San Diego Region Counties, Cities, & Other Local Agencies	\$63.8	\$195.1	\$215.3

* The statewide total is less than the combined shift in 1993-94 because some elements of the original shift formulae were changed or never materialized.

Sources: California Legislative Analyst's Office and County of San Diego, Auditor and Controller.

The ERAF legislation not only helped the state to balance its budget in the early 1990's but also contributes to the current state surplus.

The current fiscal year 1999-2000 is the eighth year in which the annual ERAF shift has been in force. During the first seven years of the program, local governments in the San Diego region have lost over \$1.26 billion in local property taxes. The amount shifted each year increases with increases in the assessed value of property.

Signed into law in 1999, Assembly Bill 1661 reduces the property tax shift by a small fraction (about 4%) or \$150 million annually statewide. The dollars will be returned to local governments and distributed on the basis of population.

CONTINUING ERAF DEBATE & COURT RULING

Since their enactment eight years ago, the property tax shifts have been an unending source of friction between state and local government. Local governments are understandably aggravated that, despite the availability of state surplus money, the Legislature has not overturned the ERAF legislation. The Legislative Analyst's Office characterizes the debate as follows:

"Defenders of the shifts justify the actions as the reversal of some of the state relief granted to local governments after Proposition 13. They contend that the state has mitigated most of the fiscal effect of the property tax shifts through Proposition 172¹⁰ and other measures. Local government officials, on the other hand, argue that the tax shifts represent a major, unwarranted interference in local affairs. They contend that the state's Proposition 13 relief was intended to be permanent, not contingent on the state fiscal fortunes and the shift mitigation measures have been limited in amount and flexibility." (Legislative Analyst's Office, *Shifting Gears: Rethinking Property Tax Shift Relief*, page 2, February 2, 1999.)

The controversy persists. Undaunted by previous failures to overturn ERAF, many local agencies still rank reversal of the property tax shifts their highest legislative priority. Local governments have gained some consolation from a recent court decision.

A Sonoma County court recently ruled that the ERAF legislation is a violation of the State Constitution's ban on unfunded state mandates. The court concluded that, in effect, the shift of local property taxes forces counties to accept responsibility for the costs of a program (schools) which is a responsibility of the state under Proposition 98. The case likely will move to the higher courts in what could be a long legal battle.

THE GROWTH MANAGEMENT CONNECTION

In addition to local government's revenue loss, a major adverse effect of the ERAF legislation is the reduction in the amount of property taxes that cities and counties receive from housing development. The financing of public services in residential areas is particularly burdensome because cities receive such a small share of the local property tax, averaging only 11 percent statewide.

Housing development has become less attractive to local governments and sales tax producing development more attractive. Local governments have less revenue to pay for needed services and infrastructure investment in residential neighborhoods, especially in older communities. All of this makes it more difficult to encourage more compact development in center cities and inner suburbs.

⁹ Redevelopment agencies were excluded from the ERAF property tax shifts beginning in 1995-96.

¹⁰ Passed by the voters in 1993, Proposition 172 provides for a 1/2-cent statewide sales tax. The state allocates the revenues to cities and counties for local public safety purposes.



NEXT STEPS?

A new state-local tax system is crucial to sustaining economic prosperity, managing growth, providing services to residents, and enhancing vital infrastructure in all communities in the San Diego region. Public agencies and taxpayers must be able to depend on their local tax dollars to fund local priorities.

The foregoing illustrations of fiscal reform and financial relief are not intended to solve all of the financial challenges facing local governments in California. But with stable revenues and different financial incentives, local governments could begin to move away from budgetary concerns and toward land use policies that provide more community balance and better economic returns.

Fiscal reform and financial relief should promote cooperation among communities in economic development and growth management, reduce the influence of sales taxes in land use decisions, and help achieve sound, sustainable growth.

New state laws and constitutional change will be required to achieve fundamental fiscal reform. Several forms of this legislation promoting the ideas discussed here are already being considered in Sacramento.

Let's challenge our local and state representatives to take on this complex issue that receives too little public attention yet affects the quality of daily life in California. We need to impress on them *that any attempts at smart growth for the future are unlikely to succeed without the kind of fundamental fiscal reform that will stop the fiscalization of local land use decisions.*

Let's urge our representatives, as well as our business and civic leaders, to find a comprehensive solution to the problems inherent in the current state-local financial relationship.



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